

Is Brexit fuelling UK inflation?

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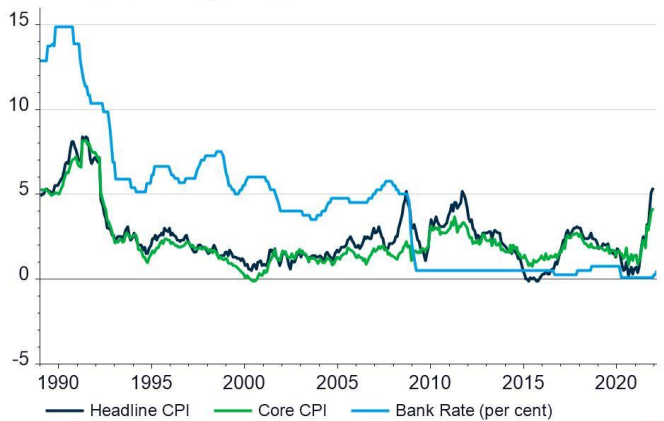


On 3 February, the Bank of England's Monetary Policy Committee (MPC) voted by a majority of five to four to raise Bank Rate by 0.25 percentage points, with four members preferring a larger 0.50 percentage point increase. However, December's headline inflation figure, at 5.4%, was around a percentage point higher than had been expected back in November, when the Bank last published its Monetary Policy Report. In a sense, this week's move represents a loosening of monetary policy over the past three months, with the nominal interest rate rising by less than inflation, implying a fall in the real rate of interest. Core inflation, which excludes energy, food, alcohol, and tobacco, was 4.2% in December, the highest reading since July 1992. In stark contrast, back then the Bank Rate was more than 900 basis points higher than it is today (9.9% as opposed to 0.5%). Policymakers continue to expect, or at least to hope, that credibility will do most of the heavy lifting, and that inflation can be brought back to target without the need for a significant tightening of monetary policy.

Large increases in energy costs explain some of the increase in UK inflation. But energy hikes are not the only story. It is likely that a reduction in aggregate supply, relative to aggregate demand, has also played a part.

UK CPI and Bank Rate

Twelve-month percentage changes



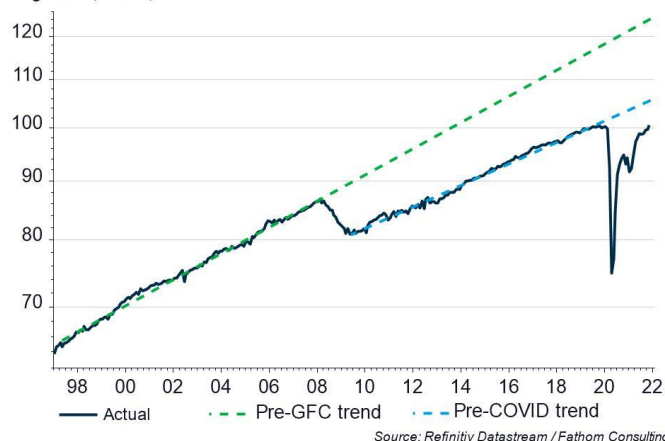
Source: Refinitiv Datastream / Fathom Consulting

In contrast to the experience of many other economies, the UK's recovery towards its pre-COVID trend level of economic activity appears to have stalled. By November, Fathom estimates that UK GDP was some 5% below its pre-pandemic trend. Why is the UK lagging behind? Apparent shortages in the UK labour market provide a clue.



UK GDP

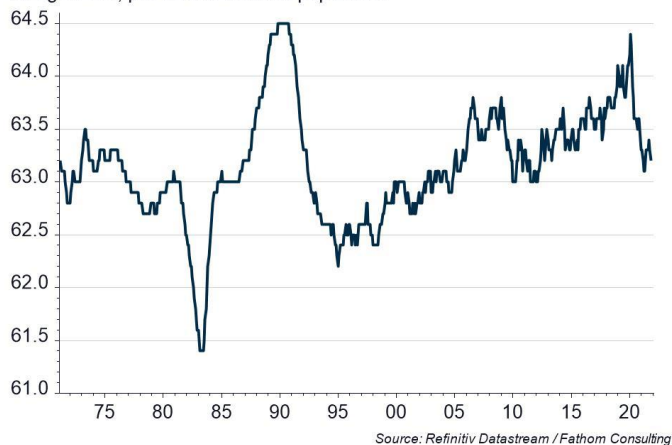
Log scale, index, 2019 = 100



Participation has fallen in many major economies since the pandemic hit in early 2020. Looking across countries, we find the change in participation is negatively correlated with the degree of excess savings. Countries that had more generous support packages for households have seen a larger fall in participation, suggesting that some workers have effectively used their savings to buy more leisure, perhaps by taking early retirement, rather than buying more goods and services. Participation has fallen in the UK, and this will explain some of the shortfall in economic activity relative to the pre-COVID trend. But, as stated above, this is not a uniquely British phenomenon.

UK labour force participation

All aged 15+, per cent of relevant population

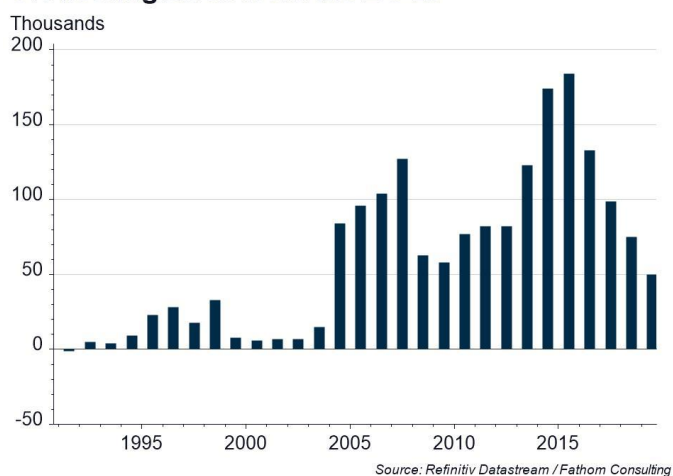


What perhaps placed additional strain on the UK's labour force is Brexit. The decade leading up to the 2016 referendum saw substantial net inward migration from the rest of the EU, increasing the size of the UK workforce. The international passenger survey (which records such flows) was suspended through most of the pandemic, and we will not get an accurate picture of the size of the UK population, taking into account net migration as well as natural change, until the 2021 Census results are published, probably in late spring.



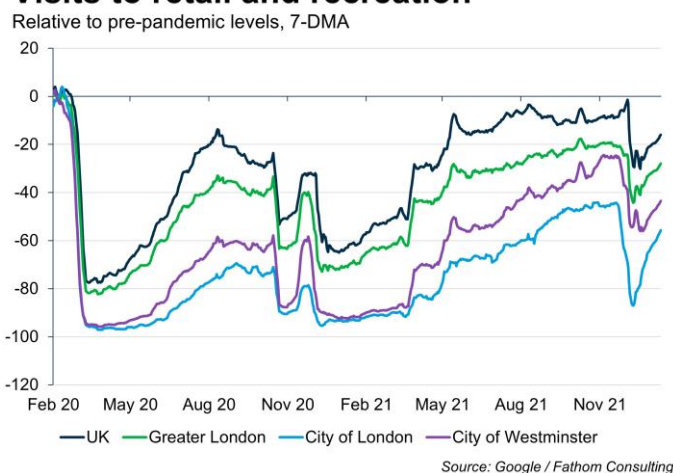


UK net migration from the EU-27



In the absence of reliable, concrete data there are a number of alternative estimates of the impact of the pandemic on the UK's foreign-born population. In November 2020, the ONS reported that it had fallen by some 700,000 between 2019 Q3 and 2020 Q3. It has subsequently revised this estimate substantially, and currently asserts there has been a small increase in the foreign-born population during the pandemic. Fathom has attempted to construct separate estimates using Google mobility data. The chart below shows that the recovery in time spent in retail and recreation in Greater London since the first lockdown has been less than across the UK as a whole. Fathom has tested the relationship between the proportion of EU-born residents in a local authority area pre-pandemic and the change in time spent in retail and recreation in that area post-pandemic and found there is a statistically significant negative. One interpretation is that we are picking up an exodus of EU-born residents during the pandemic.

Visits to retail and recreation



This simple model, based on smartphone tracking, suggests the UK's foreign-born population may have fallen by close to 1.3 million since the pandemic hit. This figure is very large, but it is also remarkably close to estimates obtained, using a completely different approach, by [O'Connor and Portes](#) early last year. Weighting together a range of estimates, Fathom's latest forecast for the UK economy assumes that there has been an 800,000 fall in the foreign-born population during the pandemic. Taken together with signs of mismatch in the UK labour market, this may imply the UK is already operating above potential, despite the fact that GDP remains somewhat below its pre-COVID trend.



Further reading

[GEMO 2022 Q1: Credibility stretched](#)



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